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Would the Proposed Bailout Affect Local Property Tax Collections?

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Executive Summary

The talk of Washington is the Bush Administration's proposal to have the federal government purchase up to \$700 billion of underperforming assets, such as mortgage-backed securities, from troubled financial institutions. Treasury Secretary Hank Paulson and Federal Reserve Chairman Ben Bernanke argue that because there is reluctance to trade short-term asset-backed securities, removing these assets from the books of investment houses and banks is necessary to prevent a "credit freeze" from spreading to the rest of the economy and stunting long-term growth.

There is much to be said about this assessment in particular and the plan in general, and its merits and pitfalls are the subject of much debate now. Legally, questions of separation of powers and the extent of congressional oversight and judicial review come to mind. We also certainly hope that policymakers will bear in mind that our tax code encourages overinvestment in owner-occupied housing, and policy solutions that preserve this distortionary policy may store up additional trouble for the future. Details on how our tax code does this can be found in past Tax Foundation publications and on our website.

This fiscal fact addresses a narrower question. Assuming that the proposal passes and the securities are transferred in some form to the federal government, and assuming that some of these securities will result in foreclosures, the federal government or one of its creations could find itself in possession of property pending disposition. (Provisions of the bill dealing with restructuring of mortgages to encourage homeowners to retain possession also imply this.) Because the federal government and its instrumentalities are immune from state taxation, a question is raised as to

whether state and local governments are in danger of a severe reduction in property tax collections as a result of the bailout proposal.

There are three likely possibilities for such a takeover, each with historical analogues. If the federal government sets up a quasi-public corporation to take title to the assets (similar to Amtrak or the activities of the Federal Deposit Insurance Corporation or the former Resolution Trust Corporation), or if the existing owners retain title but receive federal funding (similar to Conrail and Fannie Mae), the property would probably be subject to state and local taxation absent congressional directive otherwise. If the federal government takes title itself or through an instrumentality (similar to the Tennessee Valley Authority or the U.S. Postal Service), the property would be exempt from state and local taxes unless Congress states otherwise. As the bailout bill is currently written, this is the case, with assets ultimately becoming the responsibility of the Treasury Department. (Admittedly, however, the bill focuses primarily on keeping the assets solvent, not contingency planning in case title devolves to the Treasury Department.) In the case of the TVA and many federal buildings, Congress has authorized payments to the states in lieu of taxes.

Federal Government Immunity from Taxation

In *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819), Chief Justice John Marshall noted on behalf of a unanimous Supreme Court, "[T]he power to tax involves the power to destroy."¹ There, the Court held that the Supremacy Clause of the U.S. Constitution necessarily means that "the States have no power, by taxation or otherwise, to retard, impede, burden, or in any manner control the operations of the constitutional laws enacted by Congress to carry into execution the powers vested in the General Government. This is, we think, the unavoidable consequence of that supremacy which the Constitution has declared."² In short, states cannot tax the federal government because to allow them to do so would frustrate the separation of federal and state powers. Subsequent decisions have further clarified and reaffirmed this general principle that federal property and activities are exempt from state taxation.³ Any state or local tax assessment on property is void so long as that property is held by the federal government.⁴

State Revenues Could Be Impacted By Removal of Property from the Tax Rolls

The question of whether the bailout would remove property from the taxation rolls is an important one, considering that state and local governments in 2008 will rely on an estimated \$397 billion in property tax collections.⁵ As of August 2008, 1.2 million homes were in foreclosure, out of 45 million mortgages outstanding.⁶ If even a fraction of the assets underlying the estimated \$12 trillion in mortgage loans falls into government title, and are immunized from state and local taxes, it could produce a severe revenue problem for local services and threaten tax increases in other areas. While the bailout bill focuses on keeping these assets solvent, the bill also assumes that the Treasury Department will have some kind of ownership or management role of underlying assets in the event of insolvency.

Whether Property Would Be Tax-Exempt Depends on the Bailout's Structure

Ultimately, the answer to this question depends on how the bailout is structured. The possibilities include:

1. The federal government establishes a quasi-public corporation to take title of the assets. This scenario would resemble Amtrak and the receivership activities of the Federal Deposit Insurance Corporation and the Resolution Trust Corporation. In these cases, property is subject to most state and local taxes unless Congress states otherwise.

2. The existing companies retain title but receive federal funding. This scenario would resemble Conrail and (pre-September) Fannie Mae. In these cases, property is subject to most state and local taxes unless Congress explicitly states otherwise.

3. The federal government takes title (itself or through a government agency) to the mortgage-backed securities. This scenario would resemble the Tennessee Valley Authority, and the U.S. Postal Service. In these cases, property is exempt from most state and local taxes unless Congress explicitly states otherwise. In the case of the TVA and many federal buildings, Congress has authorized payments to the states in lieu of taxes.

An analysis of these past structures suggests that receiving a federal charter by itself does not immunize a corporation from state and local tax obligations. In each of the cited examples, any tax immunity resulted from either explicit congressional action or status as a federal instrumentality.

- **Amtrak.** The 1970 law creating Amtrak (chartered in the District of Columbia⁷) relieved private railroads of an obligation to provide passenger rail service in return for a contribution to Amtrak of equipment, facilities, trackage rights, and in some cases, equity. Initially, Amtrak did pay state and local taxes, primarily property taxes.⁸ (Amtrak has never turned a profit and thus would generally not be liable for corporate income taxes.) In 1979, the Department of Transportation estimated that Amtrak was paying \$14 million a year in state and local taxes, and concluded that such payments "on a primarily Federal investment are inappropriate."⁹ The Senate agreed, arguing that federal subsidies to Amtrak were being used to "provide tax windfalls to states and localities."¹⁰ After a one-year moratorium forbidding Amtrak from using its funds to pay state or local taxes, 45 U.S.C. Sec. 546(b) was enacted, which exempts Amtrak from paying "any taxes or fees imposed by any State," including sales taxes.¹¹ This statute overrides any state statutes attempting to collect these taxes.¹² According to Amtrak today, "Pursuant to the provisions of Title 49 of the United States Code, Section 24-301, Amtrak is exempt from all state and local taxes, including income and franchise taxes that are directly levied against [it]."¹³ Thus, Amtrak is essentially a private corporation owned by the federal government (with its Board is appointed by the President and confirmed by the Senate), and not an agency or instrumentality of the federal government, and it had an obligation to pay state and local property and sales taxes until relieved of that burden by explicit congressional action.
- **Federal Deposit Insurance Corporation (FDIC).** The FDIC was established in 1933 as an independent agency of the federal government, with its board is appointed by the President with the confirmation by the Senate, although it receives (as of now) no federal funds.¹⁴ Instead, any payments the FDIC makes upon taking over a failed bank come from insurance premiums paid by member banks. Under federal law, all FDIC property is exempt from taxation by federal, state, and local governments.¹⁵ However, in its activities as receiver (operating and disposing of the assets of a failed bank), the FDIC is exempt from taxation except as to property taxes, so long as the property tax does not exceed the

tax imposed on similar private property.¹⁶ Property in FDIC receivership cannot "be subject to levy, attachment, garnishment, foreclosure, or sale without the consent of the Corporation,"¹⁷ although the FDIC has clarified that it will pay liens on property placed before it became receiver, will permit additional liens to be added but forbids foreclosure, and is not liable for liens if the FDIC abandons the property.¹⁸ In short, although the FDIC as a federal entity would generally be exempt from state and local taxes, it pays property taxes on real property held as receiver by explicit federal statute.

- ***Resolution Trust Corporation.***¹⁹ Between 1989 and 1995, the Resolution Trust Corporation was appointed conservator or receiver²⁰ to 747 failed thrifts with total assets of \$394 billion,²¹ a structure similar to bankruptcy proceedings. A separate CEO reported to Congress and the President.²² Under 12 U.S.C. Sec. 1441a, the Resolution Trust Corporation had "the same powers and rights to carry out its duties . . . as the Federal Deposit Insurance Corporation."²³ At least one news report at the time expressed concern that the bailout of the savings and loan industry would remove property from state and local tax rolls, threatening revenues.²⁴ A policy statement regarding state and local taxes issued by the RTC in 1991 is almost word-for-word the same as that of the FDIC.²⁵ Similar to the FDIC, while immune from sales or excise taxes, "[o]wned real property of the [RTC] is subject to state and local real property taxes, if those taxes are assessed according to the property's value."²⁶ Even "property not owned by the Corporation, but in which the Corporation has a lien interest, . . . property taxes (including interest) secured by a valid lien with priority over the Corporation's lien interest will be paid," except in the case of abandonment by the RTC.²⁷ Thus, property held by the RTC continued to pay property taxes to state and local government, and those governments could maintain any liens on property that had failed to pay taxes prior to the beginning of the RTC receivership.
- ***United States Postal Service.*** In 1970, the Cabinet-level Post Office Department was replaced by an independent agency within the executive branch, without a separate corporate charter.²⁸ As an entity of the federal government, it neither collects nor pays state sales, property or income taxes.²⁹ (Interestingly, the Service pays federal gasoline tax, though only Kentucky and Oregon indicated that the Postal Service is not exempt from their state gasoline tax.³⁰) The property held by the USPS was valued in 2006 at \$23.1 billion, all exempt from tax with one quasi-exception.³¹
- ***Tennessee Valley Authority.*** The Tennessee Valley Authority is a federally chartered corporation that provides electricity and flood control for parts of seven states.³² While the TVA is wholly owned by the federal government and its board is appointed by the President and confirmed by the Senate, it no longer receives federal funds and is subject to some (but not all) disclosure and filing requirements applicable to private corporations.³³ Since its creation, under Sec. 13 of the Tennessee Valley Authority Act, the TVA must pay 5 percent of gross sales as "payments in lieu of taxes" (PILOTs) to state and local governments.³⁴ PILOTs are used in many cases to compensate state and local governments for the property taxes lost by the presence of federally owned property.³⁵ Other than those payments, "the [TVA], its property, franchises and income, are hereby expressly exempted from taxation in any manner or form by any State, county, municipality, or any subdivision or district thereof."³⁶ In 2006 TVA's PILOT payments totaled \$376 million, divided

roughly in half between state and local governments.³⁷ Although its structure would have allowed for taxation, the TVA was given an exemption which enabled it to construct subsidized projects and drive private competitors out of the market.³⁸ It can be surmised that to prevent state and local opposition to this federal plan, the PILOT payments were added. The payments, as a fixed percentage of receipts, also have the benefit of ensuring the TVA would not be subjected to punitive state taxation.

- **Conrail.** During the 1970s, most major railroads in the Northeastern United States entered bankruptcy protection. The largest of these railroads, the Penn Central, had been operated from 1970 onward under trusteeship pending disposition of its bankruptcy case, but at a continual loss. After the judge overseeing the case determined that no private reorganization plan was viable and threatened to order liquidation of the property, Congress reacted by passing the Rail Reorganization Act of 1973. This bill set up a federal corporation (the U.S. Railway Association) to develop a plan to repair, rationalize, and streamline the infrastructure of the bankrupt railroads, and also set up the Consolidated Rail Corporation, a separate entity, incorporated in Pennsylvania, to operate the system. Conrail, as it came to be known, began operations in 1976, became profitable in 1981, and was privatized in 1987. Though recognizing that discriminatory state taxation of the railroad industry had contributed to the decline of the railroads, Congress in 1976 only went so far as to insist that the taxation of railroad property not exceed that of comparable property.³⁹ Therefore, Conrail was still liable for paying state and local taxes until, in a situation similar to Amtrak's, the federal government recognized that its subsidies to Conrail were effectively providing a windfall to state and local governments. In 1981, Congress enacted 45 U.S.C. Sec. 727(c), exempting Conrail from state and local taxes, an exemption that was later repealed in 1986 as Conrail became profitable and was being prepared for privatization.⁴⁰ In short, Conrail had a state charter, received federal funds, and was wholly owned by the federal government, yet it had an obligation to pay state and local taxes except during the period when such payments were explicitly excluded by Congress.
- **Fannie Mae.** Fannie Mae was established in 1938 as a government agency to create and monopolize the secondary mortgage market. In 1954, it became an independent federally chartered corporation but government control remained. Between 1968 and 1970, controlling interest in Fannie Mae was transferred to private shareholders, although many argue that the federal charter and implicit federal backing prevented transition to a truly private company.⁴¹ Notwithstanding this fact, from 1970 onward, Fannie Mae paid applicable federal and state taxes, including property taxes, with the exception of state income taxes, which Fannie Mae's federal charter explicitly exempted.⁴²

A contemporary example for which information is not fully available is the bailout of American Insurance Group (AIG) on September 16, 2008, where the federal government purchased 79.9 percent of the company's shares in return for an \$85 billion loan at 11.5% interest. A Democratic Party proposal to deal with the current wave of bank failures is modeled on the AIG purchase. In return for the government's purchase of nonperforming assets from financial companies, "removing them from their books," the government should gain an equity stake. In the AIG case, although the government is the majority shareholder, AIG retains its separate corporate form and

is not considered an entity of the federal government. Therefore, it would not benefit from governmental immunity to tax obligations absent additional congressional action.

Conclusion

It is unlikely that the bailout proposal, if enacted, would significantly harm state and local property tax revenues. While it is true that the federal government or one of its creations would probably find itself in possession of property pending disposition, and while it is true that federal property is generally exempt from state and local taxes, past experience suggests that state and local governments need not worry.

If the federal government sets up a quasi-public corporation to take title to the assets, or if the existing owners retain title but receive federal funding, the property would be subject to state taxation absent congressional directive otherwise. If the federal government takes title itself or through an agency or instrumentality, the property would be exempt from state taxes. As the bailout bill is currently written, this is the case, with assets ultimately becoming the responsibility of the Treasury Department. (Admittedly, however, the bill focuses primarily on keeping the assets solvent, not contingency planning in case title devolves to the Treasury Department.) In the past, in this case, Congress has authorized payments in lieu of taxes.

Notes

1 *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 431 (1819).

2 *Id.* at 436.

3 *See, e.g., Telegraph Co. v. Texas*, 105 U.S. 460 (1881) (holding that a generally applicable tax on an activity is void when applied to federal government activities); *Van Brocklin v. Tennessee*, 117 U.S. 151 (1886) (holding that a state cannot assess taxes on government property, even as a lien to be paid by a subsequent private landowner).

4 There are instances where a state or local tax *assessment* can be valid yet the tax still constitutionally uncollectable. In *Permanent Mission of India v. City of New York*, 551 U.S. ____, 127 S.Ct. 2352 (2007), for example, the Supreme Court held that New York City's assessment of taxes on retail portions of diplomatic property was valid. However, because New York cannot enforce the collection of taxes from diplomatic property due to sovereign immunity, the city instead sought to impose a tax lien that would be paid by the next private owner of the property (encumbering the property and, to some extent, reducing its sale price). The Supreme Court upheld the action.

5 *See* Gerald Prante, *State-Local Tax Burdens Dip As Income Growth Outpaces Tax Growth*, Tax Foundation Special Report No. 163 (Aug. 2008), at <http://www.taxfoundation.org/news/show/22320.html>.

6 See Les Christie, "Homes in foreclosure top 1.2 million," CNNMoney.com (Sep. 5, 2008), at http://money.cnn.com/2008/09/05/real_estate/foreclosures_rise_again/?postversion=2008090513.

7 Federal Railroad Administration, "Amtrak," at <http://www.fra.dot.gov/us/content/30>.

8 See, e.g., *N.R.P.C. v. Commonwealth of Pennsylvania Public Utility Commission*, 848 F.2d 436 (3d Cir. 1988).

9 *Id.*, citing S. Rep. No. 253, 97th Cong., 1st Sess. 103 (1981).

10 *Id.*

11 New York State Department of Taxation and Finance, "Taxable Status of Conrail and Amtrak," (Dec. 1982), at http://www.tax.state.ny.us/pdf/memos/sales/m82_32s.pdf.

12 See, e.g., Office of the Attorney General, State of North Dakota, Opinion No. 82-24 (Apr. 8, 1982) ("It is therefore clear that the 1981 assessment of Amtrak's property, which consisted entirely of personal property, is invalid and that the property is exempt under federal law from taxation in North Dakota."), at <http://www.ag.state.nd.us/opinions/1982/Formal/82-24.pdf>.

13 National Railroad Passenger Corporation and Subsidiaries (Amtrak), "Consolidated Financial Statements for the Years Ended September 30, 2007 and 2006 (Jan. 2008) at 12, at <http://www.amtrak.com/pdf/07financial.pdf>.

14 Federal Deposit Insurance Corporation, "Who is the FDIC?" at <http://www.fdic.gov/about/learn/symbol/index.html>.

15 12 U.S.C. 1825(a).

16 12 U.S.C. 1825(b)(1).

17 12 U.S.C. 1825(b)(2).

18 Federal Deposit Insurance Corporation, "FDIC Statement of Policy Regarding the Payment of State and Local Property Taxes," 61 Fed. Reg. 65057 (Dec. 10, 1996), at <http://www.fdic.gov/regulations/laws/rules/5000-2700.html>.

19 Former Treasury Secretary Nicholas Brady, former Comptroller of the Currency Eugene Ludwig, and former Federal Reserve Chairman Paul Volcker recently endorsed re-establishing the RTC to act as the vehicle for disposing of the government's purchase of the underperforming mortgage-based assets. See Nicholas Brady, Eugene Ludwig, & Paul Volcker, "Resurrect the Resolution Trust Corp.," *The Wall Street Journal* (Sep. 17, 2008), at <http://online.wsj.com/article/SB122161086005145779.html>.

20 A conservator has the goal of maintaining the entity's "going-concern" value as a whole. A receiver has greater powers to dispose of the entity in whole or in part.

- 21 Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, FDIC Banking Review 27 (Dec. 2000), at http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf.
- 22 See Lee Davison, *The Resolution Trust Corporation and Congress, 1989-1993*, FDIC Banking Review, at <http://www.fdic.gov/bank/analytical/banking/2007apr/article1/index.html>.
- 23 *Sadeghian v. City of Denton*, No. 2-00-063-CV (Tx. Ct. App. 2nd Dist. Dec. 7, 2000), at <http://www.2ndcoa.courts.state.tx.us/case/opinions/ops2001/200063CV.wpd>.
- 24 See Peter Schmidt, "School Group Seeks Payment of Taxes in Thrift Bailout," Education Week (May 9, 1990), at <http://www.edweek.org/ew/articles/1990/05/09/09390042.h09.html>.
- 25 See Resolution Trust Corporation, "Property Tax Policy," 56 Fed. Reg. 119 (Jun. 20, 1991), at http://www.boe.ca.gov/proptaxes/pdf/91_72.pdf.
- 26 *Id.*
- 27 *Id.*
- 28 See, e.g., *United States Postal Service v. Flamingo Industries*, 540 U.S. 736 (2004) (describing the history and structure of the U.S. Postal Service).
- 29 See Institute for the Research on the Economics of Taxation, "Government-Imposed Advantages and Burdens on the Postal Service's Competitive Products: Two Wrongs Do Not Make a Right," IRET Policy Bulletin No. 91 (Jul. 30, 2007), at <http://iret.org/pub/BLTN-91.PDF>. The report also details other implicit and explicit subsidies and benefits enjoyed by the U.S. Postal Service due to its status as a federal entity.
- 30 *Id.* at 11.
- 31 *Id.* at 8. The quasi-exception is for property leased by the Postal Service from a private landlord. In these cases, the landlord "presumably pass[es] along the taxes in the rents they charge" to the Postal Service. *Id.*
- 32 Tennessee Valley Authority, "Frequently Asked Questions About TVA," <http://www.tva.gov/abouttva/keyfacts.htm#tvataxes>.
- 33 See Letter of Maureen H. Dunn, Executive Vice President and General Counsel to the Tennessee Valley Authority to Carol McGee, Securities and Exchange Commission, Dec. 8, 2006, at <http://www.sec.gov/divisions/corpfm/cf-noaction/tva121406-sec12-incoming.pdf>.
- 34 16 U.S.C. 831(k)-1.
- 35 See Advisory Committee on Intergovernmental Relations, "Payments in Lieu of Taxes on Federal Property" (Oct. 1981), at <http://www.library.unt.edu/gpo/acir/Reports/brief/B-5.pdf>.

36 *Id.*

37 Tennessee Valley Authority, "Frequently Asked Questions About TVA," <http://www.tva.gov/abouttva/keyfacts.htm#tvataxes>; Tennessee House Finance, Ways, and Means, Committee, "State Shared Taxes in Tennessee" (Jun. 14, 2002), at http://www.state.tn.us/tacir/PDF_FILES/Presentations/State%20Shared%20Tax%20Distributions.pdf.

38 *See, e.g., Tennessee Electric Power Co. v. TVA*, 306 U.S. 118, 151 (1939) (Butler, J., dissenting) ("[The TVA] attempt[s] to coerce complainants to sell distribution systems and transmission lines, in territories which defendants intend to appropriate at prices far below fair value by threatening that, unless complainants accede, they will construct, or cause to be constructed, duplicate facilities subsidized in construction and operation by federal funds and render complainants' properties wholly valueless."). The Court's opinion describes the TVA as a federal instrumentality by virtue of its federal charter. *See id.* at 134.

39 *See* Tax Foundation brief in *CSX Transportation, Inc. v. Ga. State Bd. of Equalization*, 128 S.Ct. 467 (U.S. Dec. 4, 2007), at <http://www.taxfoundation.org/research/show/22518.html>.

40 *See, e.g., Consolidated Rail Corp. v. Dep't. of Revenue*, No. 94-L-50653 (Ill. Ct. App. Dec. 9, 1997) (describing history of Conrail's tax status).

41 *See, e.g., Samuel Staley & Anthony Randazzo, Freddie and Fannie Mae Were Never Privatized*, Reason.org (Sep. 18, 2008), at http://www.reason.org/commentaries/staley_20080918.shtml.

42 Fannie Mae, "Frequently Asked Questions: Does Fannie Mae pay taxes?," at http://www.fanniemae.com/faq/cs_faq4.jhtml?p=FAQ.

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